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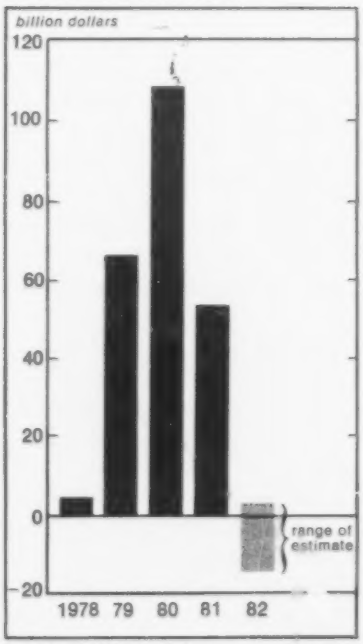
OPEC's Surplus Vanishes

Once again a massive OPEC surplus has disappeared. This time around, it shrank even more quickly than after the 1973-74 price shock. In 1980, the combined current-account position of the OPEC membership showed a surplus of nearly $110 billion. Over the first half of this year OPEC will incur a significant current-account deficit. For 1982 as a whole, the best OPEC can expect is a current account that is close to balance, and an aggregate deficit of $15 billion or so is clearly possible.

The decline in the OPEC surplus last year reflected both a rapid growth of imports and a decline in oil revenues. The shift this year is primarily the result of reduced oil revenues, particularly lower export volumes. OPEC oil exports (excluding natural gas liquids) in 1981 averaged 19.6 million barrels per day (mbd). This year the volume of oil exports is projected to fall in the 16-17 mbd range, implying total OPEC production of 19-20 mbd. The higher estimate presumes about a 2% fall in free-world oil consumption compared with last year and an average stock drawdown of 1.2 mbd. For this estimate to be realized, however, there must be a significant recovery in the level of economic activity in the OECD countries over the second half of the year.

OPEC current-account balances*



*Including official transfers

While there has been much speculation as to the possibility of a sharp fall in oil prices from current levels, the suspicion here is that the current structure of OPEC contract prices will hold through year-end. However, significant discounting in various forms, such as spot sales and bilateral arrangements, over the next quarter or two will result in an average effective price of roughly $32.50—less than the projected average contract price for 1982 as a whole of $33.20.

The $110-120 billion swing in OPEC savings over the past two years is a shift of enormous magnitude—close to 1% of the combined GNP of the non-centrally-planned economies. This has been offset in part by savings increases in oil-importing countries, but *ex ante* global savings have clearly been reduced. This shift has probably had little if anything to do with the very high level of real interest rates of the past year. Looking forward, however, the reduction in global savings implied by the disappearance of the OPEC surplus could prove to be a significant offset to the downward push on real borrowing costs implied by the prospect of a resolution of the conflict in the U.S. between inflation expectations and Federal Reserve money-growth targets. In short, real interest rates could stay higher for longer than had been expected.

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Swiss monetary policy eased, prompting fall in interest rates.

Switzerland's continued economic slowdown, coupled with expectations that inflation pressures will subside somewhat this year, has led the Swiss National Bank (SNB) to ease its monetary policy. As signs of the economy's growth tailing off have become apparent over the past few months, a consensus has emerged among economic forecasters that real GDP will fall by some 1% this year. This and recent movements in the Swiss franc exchange rate have helped to calm central bank fears about inflation, which last year averaged 6.5% at an annual rate. Over the past six months, the Swiss franc has appreciated 10% in real, trade-weighted terms. At the same time, however, the SNB has been particularly concerned about the franc's strength relative to the German mark. Substantial liquidity has now been injected into the banking system. And as a result, Swiss short-term interest rates have fallen by some 4% since the beginning of the year. As monetary growth picks up, the Swiss franc may weaken appreciably in terms of the mark, bringing a halt to the decline in interest rates.

Dutch current account in surplus last year owing to striking advance in trade balance.

Holland registered a sharp turnaround in the current account of its balance of payments in 1981. According to provisional figures, the current account showed a surplus of 8.65 billion guilders last year compared with a deficit of 4.48 billion in 1980. Much of the reversal was attributable to a 12.7-billion-guilder improvement in the Dutch trade balance, which by far offset a 400-million-guilder decline in invisibles. A sharp domestic recession which reduced import demand and higher prices for Dutch natural gas exports contributed to the dramatic improvement in the trade balance, but perhaps even more important was the emergence of a competitive advantage for Dutch exports. International competitiveness advanced markedly as the effective (trade-weighted) exchange rate of the guilder depreciated by almost 7%, while Dutch labor costs rose by much less than those of the country's trading partners. This year, the current account is expected to show another substantial surplus, although it is not likely to be as large as in 1981.

Export surge boosts Turkey's trade balance.

Turkish exports rose by some 62% in 1981, helping to narrow the country's current-account deficit to $2.07 billion from $3.29 billion in 1980. A substantial devaluation of the Turkish lira, weak domestic demand, and liberalized foreign-trade regulations induced producers to switch from domestic to foreign markets. Moreover, the Iran-Iraq war increased demand for Turkish goods significantly, as exports could be brought into these countries via land routes. In addition, interest-rate subsidies to exporters allowed companies to obtain cheap credit by exporting. While exports are expected to show another healthy rise this year, a key question for the trade-balance outlook rests on whether Turkey's industrial structure is becoming less import-intensive. If so, then a recovery in production owing to stronger export demand would not necessarily be followed by a sharp rise in imports.

Jamaica: positive developments among continuing problems.

After nine consecutive years of decline, the Jamaican economy at long last registered positive real growth in 1981. Based on strength in the construction and agricultural sectors, real GDP rose 1.2%—a modest turnaround from the 23% cumulative decline since 1972, but nevertheless noteworthy. Other encouraging economic developments included a dramatic drop in the rate of inflation—to 6% in December from 29% a year earlier—and a two-percentage-point fall in the unemployment rate down to 26%. The inflation progress reflected a big improvement in the availability of goods, as well as softer world oil prices, and tighter demand-management policies. In the external area, however, Jamaica posted a threefold widening of the current-account deficit to $463 million, as exports fell far short of expectations. Bauxite and alumina sales stagnated because of sluggish world demand, while production of sugar and bananas continued the declining trend of the past decade. Imports, on the other hand, increased sharply—up 18%—reflecting liberalization policies and pent-up consumer demand. Tourism activity, in spite of some expansion, remained sluggish owing to the depressed level of economic activity in the industrial countries.

Brazil adopts money and credit targets as anti-inflation strategy.

Brazilian monetary authorities are restricting the growth of money and credit in a continuing effort to bring down the country's high rate of inflation. The inflation rate has declined this year, but the reduction has been small: from an annual rate of 95% in December to almost 92% in March. Consequently, the National Monetary Council has set restrictions aimed at keeping the growth of commercial bank credit for this year's second quarter to 9%, following a 5% expansion in the first quarter. For all of 1982, the credit growth target is 50% for large commercial banks—down from last year when bank credit jumped by 110%. As a result of strong loan demand and the restraint program, domestic lending rates are currently at around 140%-150% per annum. Although high in real terms, these rates also act to stimulate the inflow of lower-cost foreign loans needed to help finance Brazil's balance-of-payments deficit. If the government's credit targets are met this year, progress could be made in both reducing inflation and meeting foreign finance needs.

India's domestic production revives, sharply slowing import growth.

The Indian economy recorded real growth of about 4.5% in fiscal 1981-82 just ended, after a sharp 7.5% rebound in growth in 1980-81. Agricultural output increased 3% or more, while industrial production surged over 8% as infrastructural bottlenecks eased. Average wholesale price inflation moderated to about 10% from 18% in 1980-81. Because of the recovery in domestic production, particularly of petroleum, import growth slowed sharply. As a result, with somewhat better export growth, the trade deficit, at around $6.8 billion, was about the same as in 1980-81. The current-account deficit, however, is likely to have risen to over $4 billion from $3.2 billion the previous year. In 1982-83, real growth is again likely to be about 4%-4.5%, and wholesale price inflation is expected to remain in the 8%-10% range. The trade and current-account deficits are likely to widen further as a big increase in investment and further liberalization measures spur imports.

New Zealand economy strongly influenced by government policies.

Government stabilization efforts have revived the New Zealand economy from last year's recession. Real economic growth for the just-ended fiscal 1981-82 is estimated to have been over 2%, compared with fiscal 1980-81 which registered an 0.8% decline according to preliminary government figures. The government largely precipitated the slump when it tightened monetary and fiscal policies in early 1980 in an attempt to minimize the domestic impact of the second oil price shock. After that strategy resulted in recession and continued inflation, the government shifted to an expansionist stance: Money supply (M1) growth accelerated to 13.7% in fiscal 1981-82 after growth of only 2% in the previous year; and the budget deficit went up by 50%. As a result, and because the oil shock had run its course, real growth did pick up. For the year ahead, slower growth is expected—probably about 1% or slightly higher—as the government may revert back to deflationary policies out of concern for inflation and an increasing current-account deficit.

Iraqi development program as yet little affected by sharp oil export decline.

Although the war between Iran and Iraq has had a major impact on Iraqi oil exports, it has yet to have a serious effect on Iraq's ambitious development program. With the closure of gulf oil export facilities, Iraqi oil production in 1981 averaged only 900,000 barrels per day, compared with 3.5 million barrels daily prior to the outbreak of war. As a result, oil export revenues fell by 65% to $9.5 billion. However, government spending continued unabated, and a record $23 billion in contracts was approved during the year. Imports, excluding military goods and services, grew by 24% resulting in a current-account deficit of $8.2 billion. Given Iraq's generous supply of foreign exchange reserves—$30 billion in late 1980—and interest-free loans from her gulf Arab allies, financing the deficit presented little problem. It is only in recent months, with no signs of an early recovery in oil exports, that there have been increasing pronouncements that imports in 1982 may be held at last year's levels or even possibly reduced.

Monetary Policy and Business Failures

The severity of the 1981-82 downturn, coming as it has after nearly three years of stagnation, has heightened fears about the mounting number of bankruptcies. The Dun and Bradstreet business failure rate in recent months has set a post-World War II record of more than 70 bankruptcies per 10,000 operating businesses. The unusually high rate has generally been attributed to the recession. Closer analysis from a somewhat different perspective, however, reveals that the greater number of bankruptcies may also be a by-product of the Federal Reserve's 1979 shift in operating strategy and its continued determination to bring down the rate of inflation.

Microeconomic theory teaches that if the price of one productive factor rises because of a supply shortfall, businesses will attempt to conserve on its usage. Because inputs are not perfectly substitutable in the short run, a major increase in the relative price of one input will usually be associated with a loss of output. Money and credit—just like labor, capital, and energy—can be thought of as factors of production in that they are used to cover payrolls and suppliers' bills. The reduced growth of the money stock and higher interest rates of the past two-and-a-half-years have had the same sort of impact on individual firms' production decisions as did the 1973-74 oil embargo and energy price hike.

The spurt in the real cost of credit has been closely associated with what can be considered a real money supply shortfall. From mid-1976 through 1978, "real" money growth—adjusted for inflation—was positive. Since 1979, however, it has been negative—sharply so over the last two years. Meanwhile, there has been an increase of 5 percentage points in the spread between the federal funds rate and the inflation rate.

Businesses will eventually adjust their operations to reflect the restricted availability of money and the higher cost of credit. But in the current transition period, two forces have worsened the impact. First, despite efforts to conserve on the use of credit, business financing pressure has increased as the rise in real interest rates has led to (1) a decline in the ratio of liquid assets to current liabilities and (2) an increase in the ratio of interest expense to cash flow. This has made total business costs more sensitive to fluctuations in interest rates. Second, the weak economy has decreased profitability, reducing firms' ability to withstand interest-rate or other cost shocks.

Thus, business failures may continue to rise over the near term. Nevertheless, stringent monetary policy has been accomplishing its primary task of slowing inflation. This has helped to bring down the cost of raw materials and other productive inputs, providing some relief to businesses and laying the foundation for a decline in the business failure rate.

Asia and Oceania — Bimonthly Survey of Business and Finance

	COUNTRIES	CURRENT BUSINESS CONDITIONS	EXPORTS		GNP IN 1980		BALANCE OF PA				
			6 months ending	12-month change	in billions of dollars	per capita	latest data	reserves (less gold) in million $	12-month change	months of imports covered	use of IM credit, mi lions of doll
Asia	Bangladesh	Military coup creates uncertainty about country's economic management.	Sept.	−13%	12.0*	$ 132	Feb.	215	− 32%	1.0	376
	Burma	New four-year plan, beginning April, targets real growth of 6.2%.	Jan.	− 3%	5.6*	174	Feb.	197	− 32%	7.4	55
	China, People's Republic	Strong recovery taking place in heavy industry.	Dec.	+16%	242.2	246	Dec.	5,048	+ 98%	3.0	508
	Hong Kong	Government budget for fiscal 1982-83 contains general tax cut and slower spending growth.	Oct.	+24%	21.5	4,290	n. a.	—	—	—	—
	India	New tax incentives proposed to spur domestic production and savings.	Nov.	−16%	159.3*	240	Nov.	5,066	− 30%	4.9	977
	Indonesia	Two foreign firms signed contract with Pertamina to build chemical complex.	Aug.	− 5%	66.3	437	Feb.	5,354	− 3%	5.1	0
	Japan	Public-works spending, housing loans accelerated to spur domestic demand.	Jan.	+ 8%	1,040.0	8,906	Feb.	27,939	+ 7%	2.4	0
	Korea	Further domestic stimulus and increased export credit likely.	Jan.	+13%	56.6	1,482	Feb.	2,821	+ 2%	1.3	1,321
	Malaysia	Prolonged drought could cut rice production by around 30%.	Oct.	−19%	22.7	1,690	Dec.	4,098	− 7%	4.3	214
	Pakistan	Poor export perfomance depresses domestic production.	Dec.	− 9%	30.6*	366	Feb.	707	+ 10%	1.6	731
	Philippines	Economy remains depressed because of poor commodity prices.	Oct.	− 5%	39.7**	801	Feb.	1,987	− 21%	2.7	925
	Singapore	Domestic demand high for construction, shipbuilding, oil rigs, and services.	Dec.	+ 6%	10.5	4,390	Nov.	7,478	+ 15%	3.2	0
	Sri Lanka	Spotty rains hurt rice crop; power situation improved.	Oct.	− 6%	4.1	277	Jan.	380	+ 46%	2.4	392
	Taiwan	Domestic investment picks up slightly, responding to government measures.	July	+15%	40.2	2,278	Aug.	4,468	+161%	2.3	0
	Thailand	Personal income taxes lowered, property tax imposed.	Dec.	+10%	36.0**	760	Feb.	1,402	− 3%	1.8	684
Oceania	Australia	Resources boom slows due to world demand uncertainties; unemployment rises to 7%.	Jan.	− 4%	137.4	9,401	Feb.	1,266	− 37%	0.6	0
	New Zealand	Mobil signed $750 million gas conversion project.	Jan.	+ 2%	22.5*	7,250	Feb.	347	− 15%	0.7	31
	Papua New Guinea	Immigration of Asian workers increases.	June	−16%	2.6	838	Feb.	399	+ 8%	n. a.	51

*Fiscal year **1981

Equity Issues Could Rise in 1982

One of the particularly troublesome aspects of the pattern of corporate financing that has emerged in the last few years is the relative dearth of new equity issues. In 1979 and 1981, for instance, the outstanding level of common stock actually declined, as stock repurchases outpaced new issues and stock swaps were executed in conjunction with takeover activities. As a result, corporate balance sheets now reflect a much greater reliance on debt financing—especially short-term instruments—than they did five years ago, exposing firms to a much greater degree of financial risk.

To a large extent, this trend reflects the poor performance of the stock market, since the cost of issuing new equity rises as a firm's stock price declines. The lackluster stock prices can be traced to several economic sources: First, corporate cash flow has been weak, owing to the prolonged slowdown in economic growth that has characterized the post-1978 period. In addition, real interest rates have remained unusually high since the latter part of 1979 when the Federal Reserve shifted to an aggregates management strategy. Finally, the economic and financial environment of recent years has been marked by substantially increased volatility that has caused investors to demand high risk premiums.

By historical standards, however, a stock market recovery is overdue. The Standard & Poor's Composite Index of 500 Common Stocks has fallen steadily over the past 16 months, compared with an average period of decline of 12 months during the other postwar bear markets. To be sure, historical comparisons can be misleading. However, a re-examination of the economic forces that help to determine stock values suggests that, on balance, a recovery in the second half of the year is quite possible.

First of all, the level of corporate cash flow that investors look for can be expected to rise in 1982. Sales should increase as lower inflation and the July tax cut leave consumers with more disposable income. At the same time, unit operating costs should fall as productivity begins to rise. In addition, because the increased depreciation allowances effectively lower the corporate tax liability, cash flow should rise.

Second, as long as the level of real interest rates remains high, it will be a negative influence on stock prices. However, to the extent that rates are determined by inflation expectations, a reasonable argument can be made that they will start to come down as inflation continues to decelerate.

Third, risk is manifested in investor perceptions of future earnings volatility. These originate from uncertainty about the economic environment and policy, which should be reduced as the economic recovery gets underway. Moreover, to the extent that default risk is relevant, this should also decline, as corporate bankruptcies become less frequent.

YMENTS		MONEY AND BANKING							COUNTRIES
		12-month changes				exchange rate in U.S. dollars	change from year earlier		
F li- lars	current influences on payments	latest data	consumer prices	latest data	money supply(M1)	April 7, 1982		current monetary conditions	
	Import restrictions remain.	Dec.	+14%	Nov.	+15%	.0520	−20%	Credit remains restrictive.	Bangladesh
	Agricultural exports to get boost under new plan.	Jan.	+ 2%	Apr.'81	+13%	.1345	−10%	Bank borrowing to finance 4.46-billion-kyat budget deficit.	Burma
	Foreign trade ministry reorganized.	Dec.	+ 3%	Dec.	+9%	.5395	−13%	Money supply surged at the end of 1981.	China, People's Republic
	Hong Kong and U.S. reach textile accord.	Oct.	+17%	Oct.	− 8%	.1716	− 9%	Foreign-currency deposits exempted from interest tax.	Hong Kong
	Tax incentives adopted to stimulate exports; import duty raised 5%.	Dec.	+13%	Sept.	+16%	.1190	− 2%	Credit conditions remain restrictive.	India
	Government seeks to replace log exports with plywood; oil production declines.	Dec.	+ 7%	Oct.	+29%	.00159	− 1%	Domestic fuel price increases heat up inflation.	Indonesia
	Capital outflows restrained in attempt to prevent further yen depreciation.	Feb.	+ 3%	Jan.	+11%	.004075	−13%	Long-term interest rates reduced 20 basis points.	Japan
	Liberalization of foreign direct investment being implemented slowly.	Jan.	+11%	Dec.	+ 5%	.00142	− 6%	Ceiling for won swap for foreign banks increased.	Korea
	Trade deficit of $319 million recorded in 1981.	Dec.	+ 9%	Dec.	+13%	.4272	− 2%	Current-account deficit will force higher external borrowing.	Malaysia
	Current-account deficit for fiscal 1981-82 could top $1.4 billion.	Dec.	+13%	Dec.	+ 9%	.1020	0	Rupee continues to depreciate against dollar.	Pakistan
	Steps taken to encourage invisibles earnings.	Jan.	+18%	Dec.	+ 4%	.1218	− 9%	New rediscount window opened for distressed industrial firms.	Philippines
	Trade deficit widens, capital inflows remain high, S$ depreciates slightly.	Jan.	+11%	Nov.	+13%	.4685	− 2%	Interest rates raised after recent declines.	Singapore
	Export prospects are dim, except for coconuts, owing to export duty change.	Dec.	+18%	Dec.	+ 7%	.0505	−12%	Rupee being held steady against dollar.	Sri Lanka
	Government bans some imports from Japan to redress bilateral trade gap.	Sept.	+15%	Sept.	+10%	.0280	− 3%	Money market eases; interest rates lowered.	Taiwan
	Import duties restructured; special import surcharge imposed.	Dec.	+12%	Oct.	+ 1%	.0460	− 9%	Withholding tax on deposit interest raised.	Thailand
	Capital inflows pick up slightly in recent months.	June	+ 9%	Dec.	+ 5%	1.0498	− 9%	Money supply growth on target; larger budget deficit likely.	Australia
	Manufacturing and wool exports slow; export subsidy cut for forest products.	June	+15%	Dec.	+14%	.7645	−16%	Share prices trending down.	New Zealand
	Various sources contribute $850 million for Ok Tedi project.	June	+ 9%	Oct.	−12%	1.4300	− 6%	Commercial borrowing will rise to fund current-account gap.	Papua New Guinea

World Interest Rates

market rates as of April 7, 1982; bond yields as of April 2, 1982

in percent per annum	U.S.	Canada	Britain	Belgium	France	Germany	Italy	Netherlands	Switzerland	Japan
Central Bank Discount Rate	13.375	15.40	13.00 intervention rate	14.00	9.50	7.50	19.00 penalty rate 22.00	8.00	5.50*	5.50
Day-to-Day Money	14.25 April 8	15.00	12.875	12.00	17.00	9.50	20.50	9.00	3.938*	7.3125
Treasury Bills 91-day, Middle Rates	13.18 discount basis	15.15	12.9375	14.65	n. a.	n. a.	20.875 90-days	no dealing	no market	5.625 two-month
Commercial Paper prime, 3-month, asked	14.00 finance paper discount basis	16.05 finance paper 15% tax w/h	12.28	12.90 Certified	16.75 Interbank	no market	no market	no market	no market	not traded
Bankers' Acceptances 3-month, asked	14.10	15.90 15% tax w/h	13.00	12.90 Certified	not traded	9.40	21.70	no market	5.875*	no market
Government Bonds Long-term, new and old issues, average yield	13.81	15.75	13.15	10.968 20% tax w/h	16.055	9.11	19.72	10.32	5.13†	7.30
Industrial Bonds prime, long-term, new and old issues, average yield	15.15 Aa Industrials	17.00	14.51	16.123	17.05	9.07	20.49	11.05	6.21†	6.65
Bank Short-Term Rate to Best Borrowers (prime rate)	16.50	17.00	14.00	17.00	18.50	13.00	21.75 ½ qtrly fee on outstdng.	11.00	9.50*	6.00
Bank Time Deposits 3-month	14.125 Cert. of Dep.	15.90	13.8125	14.65	16.75	9.20	10.75	8.375 large deposits	5.00* residents only	3.75 20% tax w/h
Eurocurrencies 3-month, asked	15.50	no market	13.75	no market	23.75	9.125	no market	8.3125	5.0625	no market
Exchange Rates—in U.S.$ rates floating against the $	—	.8122	1.7630	.0220	.1592	.4145	.000754	.3745	.5089	.00407
Forward Exchange Cover 3-month, in percent p.a. *D* = discount, *P* = premium	—	.787 *D*	1.636 *P*	2.455 *D*	7.523 *D*	5.269 *P*	10.066 *D*	7.158 *P*	10.260 *P*	8.740 *P*

Eurodollar Deposits
(London, interbank, bid)
April 8

7-day	15.125
1-month	15.50
3-month	15.5625
6-month	15.625

International Arbitrage
(3-month, hedged) + *in favor of U.S. dollars*

U.S.-U.K. Treasury Bills	−1.216
U.S.-Canada Treasury Bills	− .433
U.S.-Canada Finance Co. Paper	−1.043
Eurodollars-U.K. Local Auth. Deposits	− .1045*

Eurobonds
(average yield on recent straight debt issues)

U.S. Dollar Bonds	
7 yrs. and under	15.25
Over 7 yrs.	n.a.
DM Bonds	
7 yrs. and under	9.75
Over 7 yrs.	9.75

Gold Price
London afternoon fixing
354.00
(per fine ounce)

The above interest rate quotations refer to the past week and may not be construed as offers by The Chase Manhattan Bank. The quotations for Bank Short-Term Rate to Best Customers, while including customary commissions, reflect neither possible other fees nor varying compensating balance requirements.
*Market rates as of April 7, 1982. †Bond yields as of April 2, 1982.

Current economic indicators of major industrial countries

	U.S.	Canada	Britain	France	Germany	Italy	Switzerland	Japan
Consumer prices*	(Feb.) 7.7	(Feb.) 11.6	(Feb.) 11.0	(Feb.) 13.9	(March) 5.2	(March) 16.1	(March) 4.7	(Feb.) 3.1
Industrial production*	(Feb.) −6.6	(Jan.) −4.9	(Jan.) −0.3	(Jan.) 1.6	(Jan.) 0	(Jan.) −1.7	n. a.	(Feb.) 3.3
Trade balance† *(billions of local currency units)*	(Feb.) −$1.2	(Jan.) C$1.29	(Jan.) −£0.13	(Feb.) −FF5.86	(Feb.) DM3.62	(Jan.) −Lit.1,540	(Feb.) −SF0.37	(Feb.) ¥308.1
Money supply (M1)*	(Feb.) +6.6	(Jan.) −2.2	(Jan.) 18.1	(Nov.) 14.8	(Jan.) −1.1	(Nov.) 7.7	(Dec.) −7.4	(Dec.) 9.7
Velocity of money (M1)*	(Dec.) 5.5	(Sept.) 15.7	(March'81) 4.5	(June) −0.2**	(Dec.) 6.6	(Sept.) 4.0**	n. a.	(Sept.) −1.1
Reserves minus gold *($ million, change from previous month)*	(Feb.) −30	(Feb.) −779	(Feb.) −155	(Feb.) 166	(Feb.) −513	(Feb.) −1,306	(Feb.) −54	(Feb.) −114

* Percent change from 12 months earlier. **based on GDP † Figures are only for the month indicated.

Wider LDC Loan Spreads Ahead?

Market sentiment appears to be growing that spreads on loans to developing countries are headed upward. Thus far, the only hard evidence of widening margins comes from the terms negotiated for recent syndicated credits to a few Latin American countries. Mexico, Argentina, and Chile have recently secured less advantageous terms than heretofore, and the high Brazilian spreads are apparently holding fast in spite of Brazil's improved balance-of-payments position. On the other hand, spreads on lending to Asian countries seem to be stickier, with terms on recent Korean and Malaysian borrowing still favorable to the borrower. Only in the case of the Philippines is there much evidence from the Asian market that higher spreads may be in the offing.

There are, however, other signs that the "borrowers' market" of the past three years is changing its tone: Maturities are shortening; the number of banks needed to be contacted in order to complete a syndication has increased; there is much more frequent resort to prime-based lending—markedly more attractive to U.S. lenders given the current differential with LIBOR-based loans; and, although the numbers are sometimes hard to pin down, front-end fees seem to be on the rise.

Bank perceptions of lending risk to the majority of the less developed countries (LDCs)—particularly those who are oil importers—have increased substantially over the past several years. Given this, the most interesting question now is not why spreads appear to be on their way up, but rather, why has it taken the market so long to demand greater rewards for greater perceived risk? In other words, why, over a period of ballooning current-account deficits and deteriorating debt-service and net foreign interest/export ratios, should the developing countries have been able to borrow on such generally favorable terms?

Although the average maturity of publicized Eurocredits fell in 1980, maturities were fairly steady through most of last year. And loan spreads have been reasonably stable on average since 1979, when they bottomed out after their slide from the 1975-76 peak. Indeed, until recently, the only evidence that the market perceived increased risks on LDC loans was the gradually widening differential between spreads on those loans versus loans to OECD members. That differential has been growing since early 1979.

The usual explanation of low lending spreads in terms of excess bank liquidity is hardly satisfying. In the first place, it is a misconception to think of international banks as being awash with funds. The great bulk of syndicated international lending is accomplished with funds borrowed competitively, and banks do not bid for funds without having previously identified attractive lending opportunities. In the second place, the most striking feature of the international financial market over the past several years has been the extremely high level of real (inflation-adjusted) interest rates. Last year the six-month LIBOR averaged 16.7%, while on a fourth-quarter-to-fourth-quarter basis U.S. inflation, as measured by the implicit GNP deflator, was only 8.8%. Such unprecedentedly high real rates of interest are hardly characteristic of an "excessively liquid" market.

What has been interpreted as a phenomenon related to excess liquidity would thus appear to be something rather different. The suspicion here is that the stickiness of spreads on loans to developing countries in recent years is the joint result of two forces: an increasingly competitive market and the availability to many international banks of funds at well below market rates.

Determining the spread

The price over LIBOR of a syndicated credit is determined by the minimum acceptable return over cost of funds to the marginal bank in the syndication—that is, the bank least willing to participate. In recent years the number of banks actively participating in international lending has grown significantly. This reflects not only smaller banks' increased access to information regarding lending opportunities in the international market, but also, in some countries, the relatively slow growth of credit demand in domestic markets.

The number of banks wanting to play a managerial role in international loan syndication has increased even more rapidly as banks have sought to protect overall rates of return in the face of lower spreads by securing a higher share of front-end income. Particularly noteworthy has been the assumption of an increased leadership role by heavily capitalized Arab banks who have high asset-growth targets and a strong desire for portfolio diversification. The predictable result of these developments has been increased downward pressure on lending spreads that has offset the perceptions of increased risk on the part of banks historically more active in international lending.

The effect on negotiated loan spreads of relatively large supplies of funds to banks at below-market rates is less clear cut. Historically, the tiering of deposit rates—that is, the emergence of significant differences between the deposit rates of most-favored and least-favored banks—has been associated with increased loan spreads. For example, although the rapid increase in spreads on loans to developing countries in 1975-76 was related in part to increased concerns about debt-service capability, it was also related to the marked

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tiering of deposit rates that followed the failure of Herstatt Bank. Indeed, a borrower in that period was sometimes given a choice between a base rate (LIBOR) defined in terms of the offer rates of the premium banks (together with a correspondingly high spread), and a base rate defined in terms of the offer rates of less favored banks (together with a correspondingly lower spread).

The deposit tiering of the past several years, however, has taken a different form. It has manifested itself not so much in terms of an increased dispersion of explicit market offer rates, but rather in the availability of funds to many banks at rates well below observed rates. This tiering of average deposit rates had its origins in the extremely rapid growth of OPEC deposits after the oil price rises of 1979-80 and in the preference by Middle Eastern countries for deposits in non-U.S. banks that followed the freeze of Iranian assets in late 1979. The increase in liability risk inherent in the rapid buildup of the accounts of an individual depositor required compensation in the form of below-market rates on those additional deposits. This held both for direct OPEC deposits and for the redeposits in U.S. banks of OPEC funds placed initially with non-U.S. banks. Since banks tend to view the marginal cost of funds as a blended rate, this availability of below-market funds to a relatively large number of banks in the 1979-81 period resulted in a significant tiering of effective marginal deposit rates. For the banks so favored, negotiated loan spreads thus understated the effective margins earned on loans and hence, the rewards entailed in assuming the risks perceived in lending to the developing countries.

The restraining influence on negotiated loan spreads of this form of deposit-rate tiering has disappeared with the rapid decline in the OPEC surpluses. Recently, however, a new concern promoting the tiering of deposit rates has emerged—the differential exposure of individual banks to Polish-asset risk.

The likelihood of continued tiering of deposit rates is of relatively little importance to the outlook for loan spreads to the developing countries, however. The key element promoting higher spreads is the need to involve an increasing number of participants in the loan syndication process, particularly for loans to the major borrowing countries. To the extent slow growth of domestic credit demand does not reduce the minimum return demanded on international lending by the historically less active institutions, they must be attracted into the market by higher spreads. When a country's borrowing needs are large, it is thus possible that spreads could be stable or even rising over a period in which the risk attached to lending to that country is generally perceived as falling.

This need to involve a larger number of financial institutions in international lending has relatively little to do with *changes* in perceptions of country risk. It is chiefly a matter of portfolio balance—the increased concentration of the debt of a relatively small number of major borrowing countries in the portfolios of the major international banks. Although the overall capital/asset ratios of the major U.S. banks have shown no tendency to deteriorate in recent years, the proportion of capital at risk in a number of individual borrowing countries has reached relatively high values. In part because of the stance taken by the regulatory authorities, these ratios will tend to increase much more slowly in the future than they have in the past. For the historically more active international banks, increases in exposure to the major borrowing countries will be more closely linked to increases in bank capital. Those countries with ambitious borrowing targets may thus need to tap institutions now outside the international market.

Most of the recent technical innovations in the international financial market can in fact be understood as a response to this need to involve a larger number of financial institutions in that market. Prime-based loans, syndicated bankers'-acceptance credits, floating-rate Euro-notes, and two-tranche loans with the short-term tranche aimed at regional banks, are all examples of this market response.

Lending-market ironies

That loan spreads to the non-oil developing countries should be expected to rise at a time when lower oil prices and lower interest rates hold out the prospect of improved debt-service capabilities is quite ironic. Overall, the net borrowing requirements of the non-oil developing countries are unlikely to increase significantly this year. Next year they are likely to fall somewhat. And although debt-service ratios will continue to rise for most nations in this group, the proportion of export receipts required to cover interest payments on net foreign debt could be close to peaking.

This more favorable outlook obviously does not hold across the board, however. The number of countries with debt-service difficulties serious enough to require debt rescheduling is growing. Furthermore, market perceptions of the risk inherent in lending to oil exporters with a high capacity for import utilization are increasing. Nonetheless, most of the major borrowing countries are importers of oil in significant quantities, and for these countries the perceived likelihood of debt-service difficulties is decreasing. Just the same, the spreads such countries will have to pay in order to cover their borrowing needs are likely to be higher in the near term than in the recent past.

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